BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CARL M. HALVORSON, INC.)

Appearances:

For Appellant: Burton M. Smith
Certified Public Accountant

For Respondent: A. Ben Jacobson,
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Carl M. Halvorson, Inc., to proposed assessments of additional franchise tax in the amounts of $4,308.13 and $4,102.98 for the taxable years ended November 30, 1950, and 1951, respectively, based on income for the year ended November 30, 1950.

Appellant is an Oregon corporation whose business is heavy construction work. Its principal stockholder is Carl M. Halvorson. It qualified to do business in California in February 1950.

For its first fiscal year, ended April 30, 1950, Appellant reported no income. Thereafter, it adopted a fiscal year ending November 30. Pursuant to former Section 13 subsection (c) of the Bank and Corporation Franchise Tax Act, which was designed to place commencing corporations on a prepayment basis, the franchise taxes for Appellant's second and third taxable years, that is, the years ended November 30, 1950, and 1951, were measured by its income for the period May 1, 1950, to November 30, 1950.

While carrying on its own projects in various western states, Appellant received substantial income during the period May 1 to November 30, 1950, through a one-third interest in a joint venture which it sponsored and managed. The joint venture had been formed with three other companies (all controlled by the Halvorson family) for the purpose of constructing a tunnel six miles long through mountains near Santa Barbara, California, under a contract with the United States Government. This construction was Appellant's only source of income in California.

The contract provided for partial payments at the end of each month as the tunnel project progressed., It also authorized the Government to retain 10 percent of each payment pending final completion and acceptance of the tunnel. Monthly bills submitted to the Government by the joint venture pursuant to the contract were based upon estimates of work completed at the end of each month. These estimates referred to specific units of work enumerated and priced in the original contract bid, and were stated largely in terms of cubic yards of excavation and cement work accomplished.

The joint venture's reported net income for the fiscal year ended August 31, 1950, reflected the full amount of its billings to date, less direct costs and expenses incurred within the period. Appellant's reported net income for its fiscal year ended November 30, 1950, took into account its distributive share of the reported net income of the joint venture., Appellant computed the amount of net income allocable to California for tax purposes by apportioning the combined net income from all its operations in accordance with a three-factor formula of property, payroll, and sales. Since its other operations showed a loss, Appellant's share of the joint venture's reported net income was only partially returned as income derived from this state.

The Franchise Tax Board, treating the tunnel project as a separate enterprise, determined that the Appellant's net income from California was its distributive share of the reported net income of the joint venture, less a portion of Appellant's general overhead expenses attributable to the joint venture. It apportioned overhead expenses between Appellant's own projects and the joint venture's project on the basis of their relative direct costs to Appellant; it gave double weight, however, rather than equal weight to the direct costs assigned by Appeliant to its own projects.

Appellant takes the position that its income derived from California should be computed according to the three-factor formula usually employed in allocating income of a multi-state unitary business. We cannot agree. It is well established that a business may be considered unitary if its various parts contribute to or are dependent upon one another. In the absence of such an interrelationship, separate accounting is the appropriate method of determining what part of the income is attributable to California. (Butler Bros. v. McColgan, 315 U. S. 501 [86 L. Ed. 991]; Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P. 2d 16]; Cal. Admin. Code, Tit. 18, § 24301 [now 25101].) Appellant has offered no evidence that its various construction projects with-in and without the state were so closely integrated and interdependent as to constitute a unitary business. The general overhead of Appellant's main office, representing those expenses which were not directly assignable to a given project,

was only about $16,000 as contrasted with over $1,000,000 in direct costs of particular jobs. This is a positive indication that centralization of functions was at a minimum. From all that appears in the record of this matter, the earnings and losses of Appellant's various projects would have been substantially the same whether or not they had been under common ownership.

Appellant next argues that, without the use of formula allocation to mitigate what it regards as the great exaggeration of net income reported by the joint venture's accounting method for the year ended August 31, 1950, such income should be re-computed by another method that clearly reflects income. Appellant states that although the joint venture used the percentage of completion method of reporting income from the tunnel project, the completed contract method would have been more suitable. It urges that distortion of income resulted from the fact that the joint venture's per unit costs during the initial phases of the project were considerably less than during later phases, while per unit billings to the Government remained constant. Appellant says that items including installation of wiring and ventilation machinery, diversion of water and removal of waste material had not been finished when the estimates and billings were made and that the percentage of completion was thus overstated.

Section 12, Subsection (1) of the Bank and Corporation **Franchise Tax Act, applicable to the year in question,** provides:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period, fiscal year or calendar year as the case may be, in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of said commissioner does clearly reflect the income...

Section 12, subsection (3), paragraph (e) thereof provides:

> Where a corporation is engaged in the performance of a contract in this State which will require more than a year to complete, the commissioner may require that the income from the contract be reported on the basis of percentage of completion unless the corporation furnishes bond or other security guaranteeing the payment of a tax measured by the income received on the completion of the contract, even though the corporation is not doing business in this State in the year subsequent to the year of completion.

Appellant has not indicated that it ever made any attempt to report its income of fiscal year 1950 by any method other than the percentage of completion system which it as well as the joint venture actually used. So we must assume that Appellant, in using that system, was simply employing its usual method of accounting or elected to use it rather than furnish security guaranteeing payment of tax measured by the income received on completion of the contract. We are not persuaded by Appellant's general statements, unsupported as they are by testimony or documentary evidence, that the estimates of the work completed on the project were significantly overstated. The undertaking was large, complex and inherently subject to unforeseeable difficulties. The estimates of the work completed were made by the joint venture of which Appellant was a member, presumably as an attempt in good faith to achieve accuracy under the then prevailing conditions. The estimates were accepted by the Government as a basis for payment and by Appellant for the purpose of reporting its income. Use of the accounting method as employed by the joint venture and by Appellant was appropriate and Appellant may not now choose to alter it retroactively. (Hegeman-Harris Co. v. United States, 23 F. Supp. 450; Lord v. United States, 184 F. Supp. 149; W. F. Trimble & Sons Co., 1 T.C. 482.)

Although the joint venture and Appellant reported as income the entire amount of the billings less expenses incurred, Appellant now contends that the 10 percent thereof retained by the Government should not have been so reported, for during the year in question the joint venture neither received nor had a right to receive the retained percentage.

The billings, however, were made in accordance with the joint venture's estimates of the amount of work completed. It was the amount of work completed, rather than the billed amounts actually received or receivable that determined the amount of reportable income. In returning the full amount of the billings, less expenses, the joint venture and Appellant were using an acceptable percentage of completion method of accounting. Therefore, the full percentage of work completed, as reflected in the billed amounts, was properly returned by the joint venture for the year ended August 31, 1950, and hence by Appellant for the year ended November 30, 1950, even though actual payment of the balance due was not to occur until final completion and acceptance of all work covered by the Government contract. (Rosa Orino, 34 B.T.A. 726; cf. L. 0. Layton, T. C. Memo., Dkt. Nos. 29968, 29969, November 19, 1952.)

The final question involves the apportionment of overhead expenses between the joint venture and Appellant's own jobs according, to their respective direct costs. In defense of its double weighting of Appellant's own direct costs in such apportionment, the Franchise Tax Board states that a contractor

engaged in his own venture and also in a joint venture, in attempting to maximize his own profits tends to assign directly to the joint venture as much overhead as possible and to build up the direct costs charged to the joint venture as compared to his own. If this be true, the overhead to be apportioned would relate in greater degree to the contractor's own jobs, the direct costs of the joint venture relative to those of the contractor's jobs would be overstated, and the resultant error would be corn-. pounded unless corrective weight were assigned to the direct costs of the contractor's own jobs.

We do not feel justified, however, in assuming that Appellant exaggerated the costs directly chargeable to the joint venture in order to maximize its own profits, especially since the joint venture was carried on by members of the same family. Unless errors in the classification of overhead expenses and direct costs and in the assignment of direct costs between different jobs have been discovered by an audit, corrective measures are inappropriate. Therefore, we hold that overhead expenses should be apportioned between Appellant's own projects and the joint venture's project in proportion to their respective direct costs, without doubling the weight of Appellant's own direct costs.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code that the action of the Franchise Tax Board on the protests of Carl M. Halvorson, Inc., to proposed assessments of additional franchise tax in the amounts of $4,308.13 and $4,102.98 for the taxable years ended November 30, 1950, and 1951, respectively, be modified as follows: Overhead expenses shall be apportioned between Appellant's own projects and the joint venture's project on the basis of their equally-weighted, relative direct costs. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 20th day of March, 1963, by the State Board of Equalization.

John W. Lynch, Chairman
Geo. R. Reilly, Member
Alan Cranston, Member
Paul R. Leake, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary